LIBRARY

Office-Supreme Court, U.S.
FILED
DEC 19 1963
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 639

STUART ARONOFF; JASON and ILEYEN BERNIE; GLORIA BOYD; ALTHEA G. CASE; CLIFFORD R. GANS; NATHAN and IDA FRANKLIN; BUD CHARLES GORE and PHYLLIS GORE; MAX and TURA KLEIGER; SAMUEL ROBINSON and ANNA ROBINSON; HYMEN SMITH and SEVERT SMITH; MARTIN SIRODY and KATHRYN SIRODY; CLYDE E. and MARY JO SHIELDS; HARRY M. SUGARMAN and MARY SUGARMAN; MAX STEIN and FAY STEIN; ROY C. TROEGER and VIRGINIA RUFF TROEGER; RICHARD H. and PATRICIA TROEGER; HARLAND and IRENE WEIR; *Appellants,*

vs.

FRANCHISE TAX BOARD of the State of California; STATE BOARD OF EQUALIZATION; JOHN W. LYNCH; GEORGE E. REILLY, PAUL R. LEAKE; RICHARD NEVINS and ALAN CRANSTON as members of the State Board of Equalization, *Appellees.*

Appeal from the Supreme Court of the State of California

Motion to Dismiss or Affirm

STANLEY MOSK
Attorney General of the
State of California

DAN KAUFMANN
Assistant Attorney General

ERNEST P. GOODMAN
Deputy Attorney General

SUBJECT INDEX

	Page
Statement of the Case	2
Statement of Facts	4
The Question Presented	7
Argument	9
No Substantial Federal Question Is Presented in This Case	9
I. There Has Been No Denial to Appellants of Procedural Due Process	9
II. There Has Been No Denial of Substantive Due Process	13
Conclusion	16
Appendix	

TABLE OF AUTHORITIES CITED

Cases	Pages
Abelleira v. District Court of Appeal, 17 Cal. 2d 280, 109 P. 2d 942	4, 7
Asher v. Johnson, 26 Cal. App. 2d 403, 79 P.2d 457	5
Boyd v. United States, 116 U.S. 616	13
Bull v. United States, 295 U.S. 247	3, 9
Commissioner v. Sullivan, 356 U.S. 27	15
Den ex dem. Murray's Lessee v. Hoboken Land & Improvement Co., 59 U.S. (18 How.) 272	3, 9
Enoch v. Williams Packing Co., 370 U.S. 1	9, 10
Gorham Mfg. Co. v. State Tax Commission, 266 U.S. 265	4, 7
Hetzel v. Franchise Tax Board, 161 Cal. App. 2d 224, 326 P. 2d 11	13, 15
Hodge v. Muscatine County, 196 U.S. 276	3, 4, 13
Lewis v. United States, 348 U.S. 419	13
Lipke v. Lederer, 259 U.S. 557	10, 11
Mathews v. Rodgers, 284 U.S. 521	9
Meyers v. Bethlehem Shipbuilding Corp., 303 U.S. 41	4, 7
Nathan H. Schur, Inc. v. City of Santa Monica, 47 Cal. 2d 11, 300 P.2d 431	5
People v. Skinner, 18 Cal. 2d 349, 115 P.2d 488	3
Phillips v. Commissioner, 283 U.S. 589	9
Prentis v. Atlantic Coast Line Co., 211 U.S. 210	4
Schur v. Johnson, 2 Cal. App. 2d 680, 38 P.2d 844	5
Spector Motors v. McLaughlin, 323 U.S. 101	8, 12
Speiser v. Randall, 357 U.S. 513	11, 12
Springer v. United States, 102 U.S. 586	3

Pages

Tank Truck Rental v. Commissioner, 356 U.S. 30 ..... 12, 15
Textile Mills Sec. Corp. v. Commissioner of Internal Revenue, 314 U.S. 326 ..... 12, 15

United States v. Kahriger, 345 U.S. 22 ..... 10, 14

Weyerhaueser v. Minnesota, 176 U.S. 550 3

CODES

California Revenue and Taxation Code:
Section 17297 ..... 2, 3, 4, 6
Section 19081 7

CONSTITUTION

California Constitution, Article XIII, Section 15 7

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 639

STUART ARONOFF; JASON and ILEYEN BERNIE; GLORIA BOYD; ALTHEA G. CASE; CLIFFORD R. GANS; NATHAN and IDA FRANKLIN; BUD CHARLES GORE and PHYLLIS GORE; MAX and TURA KLEIGER; SAMUEL ROBINSON and ANNA ROBINSON; HYMEN SMITH and SEVERT SMITH; MARTIN SIRODY and KATHRYN SIRODY; CLYDE E. and MARY JO SHIELDS; HARRY M. SUGARMAN and MARY SUGARMAN; MAX STEIN and FAY STEIN; ROY C. TROEGER and VIRGINIA RUFF TROEGER; RICHARD H. and PATRICIA TROEGER; HARLAND and IRENE WEIR;

Appellants,

vs.

FRANCHISE TAX BOARD of the State of California; STATE BOARD OF EQUALIZATION; JOHN W. LYNCH; GEORGE E. REILLY, PAUL R. LEAKE; RICHARD NEVINS and ALAN CRANSTON as members of the State Board of Equalization,

Appellees.

Appeal from the Supreme Court of the State of California

Motion to Dismiss or Affirm

Appellees, pursuant to Rule 16 of the Revised Rules of the Supreme Court of the United States, move the Court to dismiss this appeal or to affirm the judgment of the Supreme Court of the State of California, for the following reasons:

There is no substantial federal question presented as a basis of jurisdiction in this Court, inasmuch as the questions presented have been foreclosed by previous decisions of this Court.

STATEMENT OF THE CASE

The controversy arose in the following manner: In 1951 the California Legislature enacted a statutory provision relating to the California Personal Income Tax Act which has the effect of denying the deduction of expenses associated with the conduct of gambling activities (Rev. & Tax. Code sec. 17297). Pursuant to this statutory provision, the Franchise Tax Board disallowed deductions claimed by appellants with respect to gross income derived from their conduct of certain games played for prizes up to $25 in value. The Franchise Tax Board had notified appellants of its intention to disallow the deductions through notices of proposed tax assessments, all of the liability therein set forth being based on activities of appellants subsequent to the effective date of the statutory provision above mentioned. Initially, appellants requested and were granted a hearing with respect to the disallowance of deductions before the Franchise Tax Board. The appellants then exercised their statutory right to appeal the disallowance of these deductions to the California State Board of Equalization where they were afforded a formal hearing. The Board of Equalization rendered a written opinion upholding the proposed assessments, a copy of which is set forth in the

Appendix hereto. Thereafter, appellants filed a petition for a rehearing before the State Board of Equalization. Prior to the time the Board of Equalization acted on such petition for a rehearing, the appellants filed a petition in the California Supreme Court for an extraordinary writ to restrain the collection of the tax assessments. In accordance with California statutory and constitutional provisions expressly barring the issuance of such writ, the California Supreme Court declined to grant the relief requested by appellants. The California Supreme Court also pointed out that appellants had failed to exhaust administrative remedies prescribed by the California statutes prior to the commencement of a court action. The appellants, after payment of the tax, will be entitled to a trial *de novo* respecting the validity of the assessments in question.

The statement, at page 1 of Appellants' Jurisdictional Statement, that "the California court upheld alleged tax assessments under section 17297 of the Revenue and Taxation Code of the State of California" is incorrect. Since, as pointed out above, there was no occasion for the California Supreme Court to pass upon the validity of the assessments in question, the appellants are, in fact, seeking to have this Court review procedural and substantive issues prior to the time such issues have been considered by the California courts with respect to these appellants. The standards applied by the California Supreme Court and California appellate courts with respect to due process in tax proceedings are, however, the same as those applied by this Honorable Court. *People v. Skinner*, 18 Cal. 2d 349, 115 P.2d 488, citing *Den ex dem. Murray's Lessee v. Hoboken Land & Improvement Co.*, 59 U.S. (18 How.) 272; *Springer v. United States*, 102 U.S. 586; *Bull v. United States*, 295 U.S. 247; *Wagerhaeuser v. Minnesota*, 176 U.S. 550; *Hodge v.*

Muscatine County, 196 U.S. 276; *Abelleira v. District Court of Appeal*, 17 Cal. 2d 280, 109 P.2d 942, citing *Meyers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41; *Prentis v. Atlantic Coast Line Co.*, 211 U.S. 210; *Gorham Mfg. Co. v. State Tax Commission*, 266 U.S. 265, among others.

In summary, the procedure followed by the State has afforded appellants complete procedural due process and there are no substantive due process questions ripe for consideration by this Court. Appellants after payment of the tax will be afforded a trial *de novo* wherein they may raise the various constitutional objections which, in this proceeding, they seek to have this Court consider prematurely.

STATEMENT OF FACTS

Both prior and subsequent to the effective date of section 17297 of the California Revenue and Taxation Code, the appellants herein conducted games in which the players would purchase one or more "bingo" type cards with 75 numbers appearing thereon out of sequence. To win a merchandise prize of a value up to $25, it was necessary to get five numbers in a row either across, up or down, or diagonally. All of the numbers to be filled in on these cards were arrived at by throwing balls into receptacles.

The initial eight numbers selected were assigned to all players. Four of the five numbers in a winning combination could be based on these eight assigned numbers while at least one number of the winning combination was arrived at by a ball subsequently thrown by the individual player. Thus, by buying more cards a player could increase his chance of winning.

Prior to the time any of the tax liability here involved had accrued, it was held in a formal opinion of the California Attorney General that this type of operation consti-

tuted an illegal gambling activity (17 Ops. Cal. Atty. Gen. 64). The opinion involved the propriety of allowing the incorporation of such an operation by Nathan Franklin, one of the appellants herein.[1]

At the time the Franchise Tax Board began its investigation with respect to appellants in 1954, the business establishments of appellants held business licenses from the City of Santa Monica. The licenses expired June 30, but were subject to renewal. However, in 1954, the Chief of Police of Santa Monica refused to renew the licenses on the ground that the games were illegal because the winners were determined by chance.

A ruling of the Santa Monica City Council upholding the licensing of these games was challenged in a court proceeding. A decision of the trial court that these games were predominantly games of chance and therefore illegal was reversed by the California Supreme Court which did not pass on the legality of the games but based its reversal on procedural grounds. (*Nathan H. Schur, Inc. v. City of Santa Monica*, 47 Cal. 2d 11, 300 P.2d 431).[2]

The Franchise Tax Board issued its notices of additional tax proposed to be assessed on or about March 15, 1955, for the years 1951, 1952 and 1953. The proposed assessments as

---

1. It would have been possible to have challenged the action of the Corporation Commissioner in denying a permit to Nathan Franklin based on this Attorney General's opinion prior to Appellants incurring any tax liability, but this remedy was not pursued. There had also been prior holdings by the District Court of Appeal that similar games constituted gambling activities (*Schur v. Johnson*, 2 Cal. App. 2d 680, 38 P.2d 844; *Asher v. Johnson*, 26 Cal. App. 2d 403, 79 P.2d 457).

2. The trial court granted a trial *de novo* on the issue of legality which included watching the games being played. The California Supreme Court concluded that the trial court should confine itself to a review of the record before the City Council to ascertain if there was substantial evidence to sustain the latter's determination.

to 1951 were limited to the period subsequent to the effective date of section 17297 of the Revenue and Taxation Code. The Franchise Tax Board at a later time also issued other such notices as to 1954. Petitioners filed a protest with the Franchise Tax Board. Subsequent thereto, petitioners requested and were granted a hearing before the Franchise Tax Board in which petitioners were afforded an opportunity to express their views and present any evidence which would demonstrate that the proposed assessments were improper.[3] Petitioners, having failed to convince the Franchise Tax Board that the proposed assessments should be abated, appealed to the State Board of Equalization.

In an extensive hearing before the State Board of Equalization, the Franchise Tax Board offered documentary and testimonial evidence including eyewitness and expert testimony. Appellants cross-examined the Board's witnesses and offered expert testimony of their own. The hearing was conducted by Mr. John W. Lynch, the Chairman of the State Board of Equalization, as a hearing officer on behalf of that Board. A transcript of the hearing was prepared and written briefs were filed with the Board of Equalization by appellants and the Franchise Tax Board.

On September 20, 1962, the Board of Equalization rendered its opinion affirming the propriety of the assessments in question. Subsequent thereto, petitions for rehearing were filed by the appellants herein which have not yet been acted upon by the State Board of Equalization. In the petitions for rehearing, appellants did not challenge the correctness of the factual statements appearing in the opinion of the State Board of Equalization.

---

3. The transcript of the protest hearing consists of seventy-one pages. Only a one page excerpt thereof has been made part of the record herein.

After the decision of the Board of Equalization was rendered, appellants along with other taxpayers who have not joined in this appeal brought an original proceeding in the California Supreme Court seeking a writ of prohibition to restrain the collection of the tax. The California Supreme Court held the issuance of such a writ to restrain the collection of the tax was barred by article XIII, section 15 of the California Constitution and by section 19081 of the California Revenue and Taxation Code.[4] In addition, the Court held the appellants had failed to exhaust their administrative remedies as required by California law which follows decisions of this Court. See *Abelleira v. District Court of Appeal*, 17 Cal. 2d 280, 109 P.2d 942, citing *Meyers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41; *Gorham Mfg. Co. v. State Tax Commission*, 266 U.S. 265. The California Supreme Court found it unnecessary to reach the numerous constitutional arguments advanced by appellants which appellants are free to raise in a trial *de novo* in the superior court. A petition for rehearing was denied by the California Supreme Court.

THE QUESTION PRESENTED

The basic issue here presented is whether a substantial federal question is raised under the following circumstances: Under California law a taxpayer is entitled to an administrative hearing and review of tax assessments by an independent administrative agency of the State before any tax is paid; the taxpayer exercises his right to such a hearing; after an adverse decision by this independent ad-

4. Section 15 of article XIII of the California Constitution and section 19081 of the Revenue and Taxation Code expressly provide that "No injunction or writ of mandate or other legal or equitable process shall issue in any suit, action or proceeding in any court against this State, or against any officer of this State to prevent or enjoin the assessment or collection of any tax. . . ."

MICRO CARD
TRADE MARK ®
22
PC 83
MATTHEW BENDER & COMPANY
MB
6-49
microcard

ministrative agency and while the taxpayer's petition for a rehearing therein is still pending, the State Supreme Court declines to issue an extraordinary writ to enjoin the collection of the tax and holds that under State law the taxpayer must exhaust his administrative remedies and pay the tax after which the taxpayer may seek a refund with interest in a trial *de novo* in the state courts, wherein he can raise all his constitutional objections to the validity of the tax assessment.

Since the California Supreme Court did not have to rule on the validity of the assessments or the validity of the statute here involved, or as to who had the burden of proof, or on the consequences which would follow in the event appellants failed to testify, appellants' statement as to the question presented bears virtually no relation to the true posture of this case. Appellants, in presenting to this Court questions relating to burden of proof, self-incrimination and the validity of the statute are asking this Court to consider matters not previously passed upon by the California courts, and are, in effect, asking this Court to guess how the California courts will construe the statute and rule on the other contentions of appellants in violation of the principles enunciated by this Court (*Spector Motors v. McLaughlin*, 323 U.S. 101, 105).

As previously pointed out, the appellants have enjoyed a full hearing before the Board of Equalization in which the representative of the Franchise Tax Board went forward with the evidence to establish that appellants were not entitled to the tax deduction which they seek and in which the appellants were afforded the opportunity to cross-examine the Franchise Tax Board's witnesses, to present evidence of their own, and to submit argument, both oral and written, and since appellants availed themselves of the opportunity so to do, appellants' references to *ex parte*

administrative proceedings and secret administrative notice are pure nonsense.

ARGUMENT

No substantial Federal Question Is Presented in This Case.

I. THERE HAS BEEN NO DENIAL TO APPELLANTS OF PROCEDURAL DUE PROCESS.

The California Supreme Court, in its opinion in this case, declined to relieve appellants of jurisdictional requirements under California law of exhausting their administrative remedies and of paying the tax assessments prior to bringing a suit in court, after appellants had enjoyed a full administrative hearing before the State Board of Equalization. It has been established by the decisions of this Court that procedural due process does not require that a hearing be granted before the tax is paid. *Bull v. United States*, 295 U.S. 247; *Den ex dem. Murray's Lessee v. Hoboken Land & Improvement Co.*, 59 U.S. (18 How.) 272; see, also, *Phillips v. Commissioner*, 283 U.S. 589; *Mathews v. Rodgers*, 284 U.S. 521; *Enoch v. Williams Packing Co.*, 370 U.S. 1.

In the instant case, as mentioned above, appellants already have enjoyed an extensive hearing at the administrative level before the Board of Equalization which rendered a written opinion denying their right to the exemptions in question. In this administrative hearing, appellants were accorded all the procedural incidents of due process in a judicial trial including the right to be confronted by the witnesses for the state, the right to cross-examine such witnesses, the right to produce testimony, and the right to make both oral and written arguments. Appellants availed themselves of all these rights. In addition, after payment of the tax, appellants will be entitled to a trial *de novo* in the superior court, in which they may urge all their constitutional objections to the assessments here involved. In the

event the decision of the superior court is unfavorable to them, appellants may take an appeal to the California appellate courts.

Insofar as the requirement of the payment of the tax before trial in the California courts is concerned, appellants are being accorded the same procedural treatment that is accorded to any business man whose claim of a deduction of a business expense is challenged by the taxing agency.

Appellants' argument as to financial hardship is not well taken since, as observed in the opinion of the California Supreme Court, the appellants, had they chosen to do so, could have taken a test case in the California courts by paying a single assessment against one of the appellants, many of which were for less than $100.[5]

In the court proceeding, of course, appellants may raise questions as to who has the burden of proving the propriety of the claimed deduction. It is readily apparent that many assessments of state taxes are challenged on constitutional grounds, but that such challenge does not avoid the necessity of exhausting administrative remedies or following the other procedures prescribed by State law.

Appellants place great reliance on *Lipke v. Lederer*, 259 U.S. 557, which was decided in 1922. To the extent that *Lipke* and the other early federal cases cited by petitioners would classify as a criminal penalty special tax treatment for certain activities which are inimical to the public interest, it is inconsistent with more recent decisions of this Court which are enumerated in *United States v. Kahriger*, 345 U.S. 22, at page 27.

A further distinction of *Lipke v. Lederer*, 259 U.S. 557, is that that case involved the summary seizure and sale of

---

5. It is to be observed in passing that under the federal tax laws financial hardship is no longer a basis for enjoining the collection of a tax. *Enoch v. Williams*, 370 U.S. 1.

property without affording the affected party a hearing of any kind. In the instant case, on the other hand, the initial assessments in question were made over eight years ago. In the interim appellants have been afforded opportunities to present evidence to the Franchise Tax Board to sustain their claim of deductions. They have been accorded a full hearing before the State Board of Equalization in which the Franchise Tax Board went forward with the evidence and appellants were afforded an opportunity to present evidence of their own to cross-examine witnesses and to make arguments, both oral and written. In the event the appellants choose to challenge the validity of the tax assessment in the state court after payment of the tax, they will be able to recover with interest any overpayment which is judicially determined to have been made. Thus, the procedures followed in this case do not in any wise parallel those involved in *Lipke v. Lederer*.

Appellants, in an effort to find support for their contentions, also refer to the decision of this Court in *Speiser v. Randall*, 357 U.S. 513.[6] The *Speiser* case is not here relevant. The problem there involved was a California statutory provision requiring a taxpayer claiming a tax exemption to execute a non-communist affidavit. If the assessor denied the exemption, the taxpayer could bring an action in the courts to challenge the assessor's determination. This Court held the statutory provision invalid as being violative of the provisions of the First Amendment of the United States Constitution respecting free speech which are incorporated into the Fourteenth Amendment. It is readily apparent that the availability of the exemption was conditioned on a matter extraneous to the computation of the tax.

---

6. Contrary to the statement at page 9 of Appellants' Jurisdictional Statement, the Franchise Tax Board was not a party in the *Speiser* case.

i.e., it was conditioned on the beliefs of the individual unrelated to the incidence, measure or rate of the property tax involved. In the instant case, on the other hand, there is a denial of a deduction in the computation of taxable income. The denial arises from the nature of the deduction claimed. It is no different than denial of a deduction for rent paid by a private person or the denial of a deduction on the ground that a claimed expense was not a reasonable and necessary business expense. A taxpayer can only deduct expenses in the manner and to the extent prescribed by statute. Certainly, there is here no greater constitutional problem than if there was a denial of a deduction for the expenses incurred in lobbying. The denial of a deduction for lobbying expense was expressly upheld in *Textile Mills Sec. Corp. v. Commissioner of Internal Revenue*, 314 U.S. 326, which was cited with approval in *Tank Truck Rental v. Commissioner*, 356 U.S. 30.

Moreover, in contrast to *Speiser v. Randall*, 357 U.S. 513, where all the facts were agreed upon and the California Supreme Court had rendered a written opinion on the various constitutional issues raised, in the instant case the only action taken by the state court was a refusal by the California Supreme Court to restrain the collection as to the tax assessments in question. The California Supreme Court quite properly found it unnecessary to express any views on the various contentions of appellants herein as to burden of proof, self-incrimination, etc. The decision of the California courts on these issues will await the commencement of a refund action by appellants after they have exhausted their administrative remedies and paid the tax. In short, the constitutional contentions raised by appellants are not ripe for consideration by this Court. *Spector Motors v. McLaughlin*, 323 U.S. 101, 105.

For the same reason, the other authorities relied on by appellants which are directed to issues not yet passed upon by the California courts are not in point, e.g. *Boyd v. United States*, 116 U.S. 616, dealing with the constitutional provision relating to self-incrimination.

II. THERE HAS BEEN NO DENIAL OF SUBSTANTIVE DUE PROCESS.

Much of appellants' argument hinges on their contention that the disallowance of deductions for expenses incurred in the conduct of illegal activities constitutes a criminal penalty. While, as will be shown herein, similar contentions have been rejected in many decisions of this Court, it is to be observed initially that the California courts have not yet passed on this contention of appellants and it may be raised by appellants in a trial *de novo* in the superior court.

That the disallowance of deductions herein does not constitute a criminal penalty is clear from *Lewis v. United States*, 348 U.S. 419, wherein arguments similar to those of appellants herein were considered and rejected by this Court. Thus, this Court held that a tax on gambling activities did not constitute a criminal penalty despite the fact that the gambling activity was being conducted in Washington, D.C. in violation of federal statutes, the Court pointing out that the federal government could tax what it also forbids. In addition, in the *Lewis* case this Court rejected a number of arguments as to self-incrimination which parallel those made by appellants in the instant case.

Moreover, it has been held by the California courts that section 17297 does not constitute a criminal penalty (*Hetzel v. Franchise Tax Board*, 161 Cal.App.2d 224, 326 P.2d 11, hearing denied by California Supreme Court). This Court will generally accept the determination of the State court on this issue unless it is clearly wrong. *Hodge v. Muscatine County*, 196 U.S. 276, 279.

This Court has recognized the propriety of special tax treatment in various situations in which the effect of the exaction is to discourage the particular activity in question. Thus, in *United States v. Kahriger*, 345 U.S. 22, this Court was concerned with the propriety of a tax on persons engaging in the business of accepting wagers which required such persons to register with the Collector of Internal Revenue. The constitutional validity of the act was challenged on the ground that Congress under the pretense of exercising its power to tax was attempting to penalize illegal intrastate gambling through the regulatory features of the act and that the registration provisions of the tax violated the privilege against self-incrimination and that such provisions were arbitrary, vague and contrary to the guarantees of the Fifth Amendment. In upholding the validity of the tax, the Court discussed the employment of the taxing power in situations which resulted in discouraging the activity in question. At page 27, this Court said:

> "Appellee would have us say that, because there is legislative history indicating a congressional motive to suppress wagering, this tax is not a proper exercise of such taxing power. In the *License Tax Cases, supra*, it was admitted that the federal license 'discouraged' the activities. The intent to curtail and hinder, as well as tax, was also manifest in the following cases, and in each of them the tax was upheld: *Veazie Bank v. Fenno*, 8 Wall. 533 (tax on paper money issued by state banks); *McCray v. United States*, 195 U.S. 27, 59 (tax on colored oleomargarine); *United States v. Doremus*, 249 U.S. 86, and *Nigro v. United States*, 276 U.S. 332 (tax on narcotics); *Sonzinsky v. United States*, 300 U.S. 506 (tax on firearms); *United States v. Sanchez*, 340 U.S. 42 (tax on marihuana).
>
> "It is conceded that a federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed. Nor is the tax invalid be-

cause the revenue obtained is negligible. Appellee, however, argues that the sole purpose of the statute is to penalize only illegal gambling in the states through the guise of a tax measure. As with the above excise taxes which we have held to be valid, the instant tax has a regulatory effect. But regardless of its regulatory effect, the wagering tax produces revenue. As such it surpasses both the narcotics and firearms taxes which we have found valid.

"It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical to the public welfare, or where, as in dealings with narcotics, the collection of the tax also is difficult. . . ."

Moreover, it has been recognized by this Court that tax deductions are a matter of legislative grace. *Commissioner v. Sullivan*, 356 U.S. 27, 28. This Court has on a number of occasions expressly sanctioned the denial of deductions of expenses incurred in activities that contravene federal or state policy; *Textile Mills Sec. Corp. v. C.I.R.*, 314 U.S. 336 (deduction for lobbying expenses denied); *Tank Truck Rentals v. Commissioner*, 356 U.S. 30 (denial of deductions for overload penalty fees imposed under State law).

The foregoing authorities also refute appellants' contention that the disallowance of tax deductions constitutes the tax a bill of attainder. Equally untenable is appellants' contention that this is a gross receipts tax, a proposition rejected in the construction of the statute by the California Courts (*Hetzel v. Franchise Tax Board*, 161 Cal. App. 2d 224, 326 P.2d 11). Moreover, appellants may, if they choose, raise such contentions in their trial *de novo* in the superior court.

It is also to be observed that the statute of limitations has long since run on any criminal prosecution with respect to the games here involved, so that appellants' contentions

as to possible self-incrimination have no factual basis and are utterly devoid of substance.

Contrary to appellants' contention at page 12 of their jurisdictional statement, as demonstrated by the discussion set forth above, there is nothing novel about denying tax deductions as to expenses which were incurred in activities violative of public policy. The difficulty of appellants' position is demonstrated by the fact they find it necessary at page 14 of their jurisdictional statement to assume and discuss fictitious statutory provisions, the enactment of which has never even been considered. It is axiomatic that this Court will not render advisory opinions as to hypothetical facts or statutory provisions.

CONCLUSION

For the reasons set forth above, the denial by the California Supreme Court of an extraordinary writ to stay the collection of the tax assessed against appellants after the hearing before the State Board of Equalization does not present any substantial federal questions. Accordingly, it is respectfully submitted that this appeal should be dismissed or in the alternative the decision of the California Supreme Court should be affirmed.

STANLEY MOSK
Attorney General of the
State of California

DAN KAUFMANN
Assistant Attorney General

ERNEST P. GOODMAN
Deputy Attorney General
600 State Building
San Francisco 2, California

Counsel for Appellees.

(Appendix Follows)

Appendix

Opinion of the State Board of Equalization
Of the State of California

In the Matter of the Appeals of
STUART ARONOFF, et al.

Appearances:

For Appellants: Thomas W. LeSage, William B. Beirne and Louis C. Hoyt, Attorneys at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel, and Israel Rogers, Assistant Counsel

OPINION

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests of a number of individuals named in the order attached hereto, against proposed assessments of additional personal income tax for the years 1951, 1952, 1953 and 1954.

Collectively, the Appellants herein operated six business establishments in the city of Santa Monica from May 23, 1951 to October 5, 1954. These business establishments were called "Blackout," "Vogue," "Jade," "Cameo," "Shamrock," and "Nate Franklin's." Each of the Appellants herein was the owner of or a partner in one or more of these businesses. In each of the business establishments a certain game was played, which will be described hereafter.

Partnership and individual tax returns were filed for the period in question. Respondent disallowed all expenses attributable to these businesses pursuant to section 17359 (now 17297) of the Revenue and Taxation Code which read:

> In computing net income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

It is Respondent's contention that the operation of the game in question was a lottery as defined in section 319 of the Penal Code. Section 319 is in Chapter 9 of Title 9 of Part 1 of the Penal Code.

The Supreme Court has declared that there are three elements of a lottery: (1) a prize, (2) distributed by chance, and (3) consideration. (*California Gasoline Retailers v. Regal Petroleum Corp.*, 50 Cal. 2d 844.) In the case of the games in question the players paid a consideration to play and prizes were awarded to winners.

Before reaching the question of whether the winners of the games were determined by chance, we must consider several contentions of Appellants as to the scope of our examination.

The six businesses each received a business license from the city of Santa Monica. The licenses expired each June 30 but were renewed. In 1954, however, the chief of police refused to renew the licenses on the ground that the games were illegal because the winners were determined by chance.

Appellants appealed to the city council and a public hearing was held on August 17, 1954. At the beginning of the hearing the city attorney stated that the issue before the council was the factual one of whether, on the basis of the evidence, it appeared that the winners of the games were determined predominantly by chance or predominantly by skill. The evidence before the city council consisted of a statement of how the games were played, this statement having formed part of the application for a license; a compilation of the actual results of a number of games; testimony of Appellant Roy C. Troeger concerning the operation of the games and offering the observation that "the experienced player will accomplish a greater number of wins than the inexperienced player"; and testimony of a physicist that the games were predominantly games of skill because the statistics compiled from the actual results of a number of games showed a grouping which could not occur as a result of chance alone. The city council's decision was that the games were predominantly games of skill.

A taxpayer of Santa Monica then brought a proceeding against the city of Santa Monica in the superior court to prohibit the city from issuing the licenses on the ground that the games were illegal lotteries. The trial judge took evidence and concluded that the games were predominantly games of chance and therefore illegal. He orally announced his decision on October 5, 1954, and the operators of the games immediately closed down.

This judgment was appealed and on August 17, 1956 the California Supreme Court reversed. (*Nathan H. Schur, Inc., v. City of Santa Monica*, 47 Cal. 2d 11.) The Supreme Court held that the only issue before the superior court was the validity of the city license, that the city council exercised a quasi-judicial function in the licensing procedure and

therefore the superior court could not receive evidence on the issue of chance but must confine itself to a review of the record before the city council to determine whether there was substantial evidence to sustain the city council's determination. In the course of its opinion the court also stated, "It should also be observed that whether licenses are or are not issued the criminal law is still open to Schur."

The parties to the proceeding never brought the matter to a retrial in the superior court because in the meantime the Santa Monica City Council had passed an ordinance prohibiting the conduct of games of the type in question.

Appellants contend that the Santa Monica City Council had jurisdiction to consider the legality of the games, that it exercised a quasi-judicial function, that it held a hearing and received evidence, that it made its decision and that the decision is now final and determinative of the issue before us.

Appellants' contentions are refuted by the above-quoted portion of the opinion in the *Schur* case to the effect that the criminal law is still open. As we read the *Schur* opinion, the reasoning is that the city council had jurisdiction to determine whether a city license should issue and its decision was final in the absence of an error of law. The city council, however, had no criminal jurisdiction and therefore its determination would have no effect on a criminal proceeding even though an identical issue might have to be decided in both the licensing and the criminal proceedings. To the same effect is *People v. Settles*, 29 Cal. App. 2d Supp. 781, which held that the possession of a city license to conduct a game of skill did not constitute a binding determination that the game was in fact a game of skill so as to be a defense in a criminal prosecution for operating an illegal lottery.

Similarly, the determination of the amount of taxes owed is independent of the city licensing procedure. The fact that there might be a common issue in both types of proceedings as applied to specific individuals is merely a coincidence and does not alter our duty to decide these appeals on the record before us.

The game in each business establishment was played by a maximum of 50 players, each of whom paid a fee to play. A merchandise prize was awarded to the winner. A seat at a counter was provided for each player. In front of each player was a receptacle divided into 75 compartments each 1⅞" square and numbered from 1 to 75. In the center of the receptacle there was an unnumbered hole 3½" square painted red. Each player was provided with rubber balls 1½" in diameter.

Each player was also provided with a card containing 75 numbers arranged in 5 columns of 15 numbers each. The first column contained the numbers 1 to 15 but arranged out of numerical sequence, the second column contained the numbers 16 to 30, similarly arranged, and so on as to the remaining columns. A player could play more than one card but paid an extra fee for additional cards. Out of all the cards used in the game no two cards had the numbers arranged in the same order.

The play began by the operator designating eight of the players to throw one ball in his receptacle in turn. Thereby eight numbers were selected and all persons playing covered the corresponding numbers on their cards with white markers. The receptacles of the eight players throwing the "set up" balls were cleared and thereupon all players began to throw "skill" balls into their respective receptacles and covered the corresponding numbers on their cards with black markers.

The winner was the player having five markers in a row horizontally, vertically or diagonally on his card with the lowest number of black markers. Speed was not a factor in winning. It was possible for two or more players to tie and ties regularly occurred.

Of the five markers in the winning combination, at least one was required to be a black marker. That is, if the numbers covered as a result of the eight "set up" balls gave a particular player five in a row he would not be declared the winner until he had thrown at least one "skill" ball in a receptacle with one of these numbers thereby replacing his white marker with a black marker.

There were introduced in evidence reports of the winning results in some 7,000 games played at one of the locations. These reports were compiled by recording as to the winner of each game the number of black markers in his winning combination and the number of black markers on his card. These reports showed a pattern of very few of the winners having less than 5 black markers on the card, a few of the winners having 10 or more black markers on the card (ranging up to 15) and the great bulk of the winners having from 5 to 9 black markers on the card. More than 30 percent of the winners had 5 black markers on the card.

As stated above, of the three elements of a lottery, consideration, prize and chance, the first two are clearly present in this case and it is only the chance element which is in issue. The test to be applied is stated in *People v. Settles*, supra, as follows:

> A game is not to be regarded as one of skill merely because that element enters into the result in some degree, or as one of chance solely because chance is a factor in producing the result. The test of the character of a game or scheme as one of chance or skill is, which of these factors is dominant in determining the result?

Respondent presented an engineer as an expert witness. He stated that in his opinion both chance and skill were present but that chance predominated over skill in determining the winners of the games. He never observed the playing of the games but based his opinion on a description of the games furnished to him and on the reports of the winning results of some 7,000 games described above.

His reasoning proceeded along several alternative lines. The relative position of a player as a result of the eight "set up" balls was determined by chance. The reports of the winning results indicated that the winner averaged 7.12 black markers on his card and 2.98 black markers in his winning combination. From this he reasoned that chance predominated over skill because the winner was unable to get a ball in a particular hole as often as half the time. He also suggested an economic analysis to the effect that if it were possible to develop some substantial skill, some players would have done so and they would win most of the time and thereby discourage the ordinary player from playing.

Appellants presented a mathematician as an expert witness. He never observed the playing of the game and based his analysis on the same data as Respondent's expert, namely, a description of the game and the reports of the winning results of over 7,000 games.

The mathematician's method was to assume that the winner was determined solely by chance and to construct a mathematical model of this hypothesis. From the model he derived certain conclusions and tested them against the results of actual games. When the actual results were substantially different from the results to be expected if the winner was determined solely by chance, he concluded that the probability was 1 in 100,000,000 that the actual results had occurred solely by chance.

Appellants' expert stated his opinion that the game was not one in which the winner was determined solely by chance. Based on his opinion that the chance probability was extremely small, he concluded that the game was predominantly one of skill. He defined "skill" as any factor which enables a player to improve the performance over chance performance.

There are two California cases (*Einzig v. Board of Police Commissioners*, 138 Cal. App. 664; and *People v. Babdaty*, 139 Cal. Supp. 791) which hold tango games to be games of chance. The tango games were almost identical to the "set up" ball phase of Appellants' games except that they did not stop at eight "set up" balls but continued until there was a winner.

In *Brown v. Board of Police Commissioners*, 58 Cal. App. 2d 473, the trial court ordered a city permit to be issued for the conduct of a game virtually identical to Appellants' games except that it had no "set up" ball feature. The balls used were "of such density that when tossed into a hole they will remain and not bounce out." The trial court had found the game to be one predominantly of skill. The trial court had watched a demonstration of the game. On appeal it was held that there was substantial evidence to sustain the finding that skill predominated.

On February 19, 1951, the Attorney General issued an opinion that a game virtually identical to Appellants' games was a game in which chance predominated. (17 Ops. Cal. Atty. Gen. 63.) The Attorney General stressed the chance basis for the selection of the first eight numbers and also said,

> Considering the factors that undoubtedly would be present, such as variance in the weight and size of the rubber ball, slight differences in the size of the slots, etc., it would appear that direct hits in selected

slots would be predominantly the result of chance and not skill.

We have found two cases from New Jersey, involving games similar to the one in question, except that they did not entail the use of "set up" balls. In *O'Brien v. Scott*, 89 A.2d 280 (N. J. Sup'r Ct.), the court concluded that skill was the dominant factor. On the other hand, it was held in *Ruben v. Keuper*, 127 A.2d 906 (N. J. Sup'r Ct.), that the game was one of chance.

We were particularly impressed by the opinion in *Ruben v. Keuper*, where the court received the testimony of a statistician as to the results of a series of games in which two experts played against two novices and the experts won about 70 percent of the games. The court said (127 A.2d 906, at 909):

> There is no denial of the factual premise that a player can develop an expertness in either of the games presently under examination sufficient to enable him to compete successfully in a contest with a novice. But plaintiffs' operations do not consist of the conduct of contests of that kind. Plaintiffs' case must be judged by what they actually do, not by a theoretical analysis of an experiment that does not characterize what occurs in their establishments. The average game they run is one in which a score or more of casual boardwalk passersby of various degress of inexpertness try their hand in competition with others of the same ilk, and against the house. These are games in which comparative novices can win an occasional prize and thus titillate themselves and others into continued participation. To them the lure is chance and not an opportunity to match skills. Whatever one may say as to the expert, there can be no question but that the average or novice player is risking his dime against the lucky contingency that his balls will fall into a winning combination sooner than those of any other contestant; . . .

In the games with which we are concerned it is clear that from the point of view of any given player the eight numbers selected as a result of the "set up" balls were selected wholly at random. The only exception was where the player had thrown one of the "set up" balls, in which case, as to that player, the other seven numbers selected as a result of the "set up" balls were selected wholly at random.

The reports of the results of actual games showed that, on the average, of the winner's winning combination of five numbers two were the result of "set up" balls. Thus, about 40 percent of the winning result was wholly by chance on this ground alone.

As to the portion of the play following the throwing of the "set up" balls, it is inevitable that in almost all instances the rubber ball bounced around considerably before it settled in one of the compartments. It would indeed be an amazing feat of skill to be able to control the direction of rebound of the ball after it struck one of the partitions in the receptacle.

We find therefore as to the games conducted by Appellants that the winners were determined predominantly by chance and that the games were illegal lotteries.

We think this conclusion is not inconsistent with the opinion expressed by Appellants' expert witness. The reason for the difference between our conclusion and his conclusion lies in his definition of chance and skill. We believe that primarily what he has measured and labelled as "skill" was merely ordinary manual dexterity by which a player was usually able to keep the ball within a particular area of the box, thus increasing his probability of having the ball land in a given hole. For example, his probability for a given hole might have been 1 in 20 instead of the blindfolded or pure chance probability of 1 in 75.

While a person who, for one reason or another, lacked ordinary manual dexterity or was blind, would no doubt have been under a handicap in competing with the other players, possession of such ordinary manual dexterity together with the ability to see for at least a short distance was not skill. This merely qualified the player for the competition and among the qualifying players the result was determined primarily by chance.

ORDER

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of the following Appellants to proposed assessments of additional personal income tax for the years and in the amounts indicated be sustained:

Appellant	Year	Amount
Stuart B. Arnoff	1951	$ 34.19
	1952	2,177.66
	1953	6,143.31
	1954	4,269.78
Jason H. and Heyne Bernie	1951	33.76
	1952	941.76
	1953	2,396.98
	1954	2,264.55
Gloria Boyd	1951	12.96
	1952	930.94
	1953	2,739.85
	1954	2,489.45
Leon Brown	1951	13.05
Irma Brown	1951	19.58
Leon and Irma Brown	1952	1,252.75
	1953	3,935.14
	1954	3,086.06

Appellant	Year	Amount
Richard Brown	1951	$ 4.83
Richard L. and Sandra Brown	1952	187.46
	1953	610.37
	1954	500.88
Althea G. Case	1951	17.76
	1952	214.88
	1953	891.89
	1954	590.90
Ralph Davis	1951	93.97
Ray Davis	1951	62.65
Ralph and Ray Davis	1952	5,249.08
	1953	10,871.27
	1954	9,586.48
Ralph Davis, Jr.	1951	17.59
Marjorie Davis	1951	6.52
Ralph, Jr., and Marjorie Ann Davis	1952	1,080.05
	1953	3,604.61
	1954	3,045.91
Allen S. and Barbara B. Feder	1951	5.21
	1952	171.34
	1953	599.13
	1954	512.47
Nathan and Ida Franklin	1951	12,839.70
	1952	23,409.14
	1953	23,406.16
	1954	54,099.66
Clifford R. Gans	1951	6,039.25
	1952	18,536.18
	1953	28,795.96
	1954	6,139.43
Bud Charles and Phyliis Gore	1951	11.67
	1952	477.63
	1953	1,910.05
	1954	2,319.26
Max and Tura Kleiger	1951	5,986.25
	1952	18,395.84
	1953	28,724.78
	1954	17,588.60
Samual and Anna Robinson	1952	8,273.24
	1953	13,502.32
	1954	3,732.17
Martin and Kathryn Strody	1952	5,008.78
	1953	10,070.03
	1954	5,230.25

Appellant	Year	Amount
Hymen and Severt Smith	1951	$ 1,602.11
	1952	28,762.48
	1953	35,148.16
	1954	19,213.06
Max and Fay Stein	1953	327.04
	1954	1,166.60
Harry M. and Mary Sugarman	1951	17.79
	1952	992.60
	1953	2,552.13
	1954	3,024.77
Roy C. Troeger	1951	71.14
Virginia Ruff Troeger	1951	20.11
Roy C. and Virginia Ruff Troeger	1952	3,957.19
Roy C. Troeger	1953	6,658.20
Virginia Ruff Troeger	1953	2,588.31
Roy C. and Virginia Ruff Troeger	1954	8,317.39
Mary Joe Troeger	1951	6.99
	1952	613.15
	1953	2,045.43
Clyde E. and Mary Joe Shields	1954	1,296.65
Richard H. Troeger	1951	3.97
Richard H. and Patricia Troeger	1952	277.26
	1953	1,043.78
	1954	1,010.33
Harland and Irene Weir	1951	3.56
	1952	129.57
	1953	425.82
	1954	365.70

Done at Sacramento, California, this 20th day of September 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman
John W. Lynch, Member
Richard Nevins, Member
Paul R. Leake, Member
....., Member

Attest:
Dixwell L. Pierce, Secretary